UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF NEW YORK

GENERAL MOTORS ACCEPTANCE CORP. Appellant, vs. FAITH ANN PEASLEE Appellee.	**07-cv-6037DGL** Appeal from Bankruptcy Case No. 06-21200
GMAC LLC Appellant, Vs. FAITH ANN PEASLEE Appellee.	**07-cv-6121** Appeal from Bankruptcy Case No. 06-21200
HSBC AUTO FINANCE Plaintiff vs. PAMELA JACKSON Defendant.	**07-cv-6072** Appeal from Bankruptcy Case No. 2-06-21044
AMERICAN SUZUKI FINANCIAL SERVICES CO., LLC Plaintiff, vs. OMAYRA MARTINEZ Defendant.	**07-cv-6202** Appeal from Bankruptcy Case No. 2-06-21403
SOVEREIGN BANK Appellant, vs. MICHAEL COLOMBAI and SHANNON A. COLOMBAI Appellees.	**07-cv-6168** Appeal from Bankruptcy Case No. 06-20264

LEAD APPEAL BRIEF FOR APPELLANTS FILED BY GMAC LLC

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STATEMENT OF APPELLATE JURISDICTION

The case before this Court is an appeal from two final orders of the Bankruptcy Court for the Western District of New York (Judge John C. Ninfo, II) entered on December 22, 2006 and January 11, 2007 in Case No. 06-21200, *In re Peaslee*.[1]

This Court has appellate jurisdiction over final judgments, orders and decrees entered by the Bankruptcy Court. 28 U.S.C. § 158(a)(1). "[T]he district court has jurisdiction to hear bankruptcy appeals . . . from bankruptcy orders that are final." *In re Palm Coast, Matanza Shores LP*, 101 F.3d 253, 256 (2d. Cir. 1996). In addition, "for purposes of appeal, the concept of 'finality' is more flexible in the bankruptcy context than in ordinary civil litigation." *Id*. Finally, "orders in bankruptcy cases may be immediately appealed if they finally dispose of discrete disputes within the larger matter." *Id*. All of the Orders appealed from dispose of discrete disputes within each bankruptcy case, and therefore are final and appealable to this Court under 28 U.S.C. § 158(a).

ISSUES PRESENTED AND STANDARD OF REVIEW

A. Issues Presented

[1] In addition to *Peaslee,* the following cases are before this Court on appeals from final orders of the Bankruptcy Court for the Western District of New York (Judge John C. Ninfo, II) entered as follows:

1. *In Re Jackson* (District Court No. 07-CV-6072): Decision and Order entered in Bankruptcy Case No. 06-21044 on January 10, 2007 (Bankruptcy Court Docket No. 44). The Notice of Appeal was filed January 19, 2007 (Bankruptcy Court Docket No. 47).

2. *In Re Martinez* (District Court No. 07-CV-6202): Decision and Order entered in Bankruptcy Case No. 07-21403 on March 1, 2007 (Bankruptcy Court Docket No. 34). A Motion to Extend Time to Appeal under Rule 8002(b) was filed on March 2, 2007 (Bankruptcy Docket No. 35), the Motion was granted by Order entered on March 12, 2007 (Bankruptcy Docket No. 38). The Notice of Appeal was filed on March 26, 2007 (Bankruptcy Docket No. 39) and an Amended Notice of Appeal was filed on March 26, 2007 (Bankruptcy Docket No. 41).

3. *In Re Colombai* (District Court No. 07-CV-6168): Decision and Order entered in Bankruptcy Case No. 07-20264 on March 1, 2007 (Bankruptcy Docket No. 60). A Notice of Appeal was filed on March 7, 2007 (Bankruptcy Docket No. 63).

1. Did the Bankruptcy Court Err in Ruling that the Obligation incurred by the Debtor to the Dealership for Financing the Unpaid Balance Owing on a Trade-in Motor Vehicle ("Negative Equity") in a Motor Vehicle Retail Installment Sale Contract was not Part of a "Purchase-Money Obligation" under New York Law and was Thus not Protected from Cramdown under §1325 of the Bankruptcy Code?

2. Did the Bankruptcy Court Err in Applying the "Transformation Rule" to the Purchase Money Obligation in this Case?

B. Standard of Review

"On appeal from a bankruptcy court, the district court will not set aside the bankruptcy court's findings of fact unless they are clearly erroneous. Fed. R. Bankr. 8013. Conclusions of law are subject to *de novo* review." *Reiber v. Option One Mortg. Corp.,* 344 B.R. 28 (W.D.N.Y. 2006). *See also, Morin v. Frontier Business Technologies***,** 288 B.R. 663, 669-70, (W.D.N.Y. 2003), *quoting In re AroChem Corp*., 176 F.3d. 610, 620 (2d Cir. 1999). Both issues before this Court -- whether the Bankruptcy Court erred in concluding that negative equity is not part of GMAC's purchase-money security interest and whether the Bankruptcy Court erred in applying the transformation rule to GMAC's claim -- are questions of law that this Court reviews *de novo*.

De novo review is particularly appropriate in this case because the issues that were before the Bankruptcy Court and are now before this Court are not fine points of bankruptcy law with respect to which the bankruptcy judge presumably would have specialized expertise. The issues before this Court involve, instead, the proper construction of the undefined term "purchase money security interest" used by Congress in what has become known as the "hanging paragraph" of Section 1325(a) of the Bankruptcy Code.

The proper construction of this undefined term presents a question of federal law that must be resolved by reference to the statutory text, the goal that Congress sought to achieve in enacting the "hanging paragraph," the prevailing commercial practice at the time of its enactment

and the pre-existing body of law, knowledge of which must be imputed to the enacting Congress. Here, the prevailing industry practice with respect to negative equity was reflected in the pre-existing laws that also addressed the purchase-money financing of motor vehicles – the federal Truth in Lending Act and its implementing Regulation Z ("TILA"), state laws governing motor vehicle retail installment sales such as the New York Motor Vehicle Retail Instalment Sales Act ("MVRISA") and Article 9 of the Uniform Commercial Code ("UCC").

STATEMENT OF THE CASE

The Debtor (Faith Ann Peaslee) financed her purchase of a new motor vehicle under a retail Installment sale contract that she entered into with a motor vehicle dealer located in New York. Under the motor vehicle retail Installment sale contract, the dealership, in its capacity as an Installment seller, retained a security interest in the motor vehicle to secure the remaining balance of the "total sale price" due under the contract. All of the amounts financed under her Installment sale contract were directly connected to her purchase of the new vehicle, including: (1) the cash price of the new vehicle; (2) the amount required to pay off the lien on the trade-in vehicle ("negative equity"); (3) certain other items directly related to the purchase of the motor vehicle; and (4) the finance charges due under the contract. It was a package deal. The dealer assigned the Installment sale contract and the security interest to GMAC, as authorized by the New York MVRISA. *E.g.*, N.Y. Pers. Prop. Law § 302(10) (McKinney Supp. 2007).

Under these circumstances, GMAC has a purchase-money security interest in the Debtor's new motor vehicle that covers the entire obligation incurred at the time of the retail Installment sale transaction, including the negative equity component. The Debtor filed Chapter 13 bankruptcy within 910 days of her motor vehicle purchase, and proposed a plan that would modify the rights of GMAC by bifurcating its claim into secured and unsecured portions based

upon the retail value of the new vehicle. Such a plan violates the Bankruptcy Code as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA").

A. The Bankruptcy Law Prior to 2005

Prior to enactment of the BAPCPA, Bankruptcy Code Sections 1325(a)(5) and 506(a)(1) allowed a Chapter 13 debtor to modify the rights of a secured creditor with a purchase-money security interest in a vehicle by bifurcating its claim into secured and unsecured portions based upon the vehicle's value at the time of the bankruptcy filing. The creditor would have a secured claim to the extent of the value of the vehicle and an unsecured claim to the extent that its claim exceeded the value of the vehicle. The portion of the creditor's claim allowed as secured would be paid in full with interest, while the unsecured portion would be paid pro-rata with other general unsecured claims.[2]

Under these pre-2005 rules, the creditor's secured claim was limited to the value of the vehicle. It did not matter what caused the remaining balance of the contract to be greater than the value of the vehicle, be it the inclusion of negative equity in the cash price of the vehicle or simply a rapid decline in the value of the vehicle. If the unpaid balance of the debt was less than the value of the vehicle, the secured portion of the claim was "crammed down" to the value of the vehicle.

B. Congress Perceives an Abuse of Cramdowns and Cures It

Congress viewed the pre-2005 use of cramdowns as abusive: "[T]hrough the BAPCPA

[2] For example, if a debtor bought a car for $20,000 and financed the purchase price, then filed a Chapter 13 case one year later when the value of the car had dropped to $13,000, the debtor could propose a Chapter 13 plan that would pay $13,000 as a secured claim with interest, and pay the remaining balance ($7,000 less payments already made) pro-rata with the other general unsecured creditors. This type of plan is commonly referred to as a "cramdown" because the secured claim is based on the value of the motor vehicle ($13,000), which is typically less than the unpaid amount of the purchase money obligation.

amendments to Section 1325(a)(5), Congress was attempting to remedy a perceived abuse by those who buy vehicles on credit on the eve of bankruptcy and then utilize the cramdown provisions of the Bankruptcy Code to pay the secured creditor a lesser amount than its full claim." *In re Payne***,** 347 B.R. 278, 280 (Bankr. S.D. Ohio 2006). To cure this abuse by debtors, Congress amended Section 1325 of the Bankruptcy Code to afford motor-vehicle financers special protection against cramdowns.

Under the BAPCPA, claims of creditors who finance the purchase of a motor vehicle for personal use within 910 days preceding bankruptcy are treated more favorably than other secured claims -- the secured claims of motor vehicle purchase-money financers are no longer limited to the value of the financed vehicle. This new treatment is required by an unnumbered or "hanging" paragraph at the end of Section 1325(a)(9),[3] which provides that Section 506 does not apply to secured creditors with purchase-money security interests in vehicles acquired by a debtor for his or her personal use within 910 days prior to the bankruptcy filing.

C. The Core Issue Before the Bankruptcy Court: Whether GMAC Has a Purchase-Money Security Interest in the Vehicle Within the Meaning of the "Hanging Paragraph"

There is no dispute that the vehicle in this case was purchased by Ms. Peaslee for her personal use within 910 days of her bankruptcy filing. The only dispute is whether the debt owing to GMAC under her motor vehicle retail installment sale contract is secured by a purchase-money security interest within the meaning of Section 1325(a)(*) of the Bankruptcy Code. The core issues presented by this appeal are whether GMAC's purchase-money security interest in the vehicle lost its protected status under the hanging paragraph because the negative

[3] The "hanging paragraph" of § 1325(a) is graced with an asterisk and is hereafter referred to as § 1325(a)(*).

equity for the trade-in vehicle was financed as part of the total sale price due under Ms. Peaslee's Installment sale contract (as expressly authorized by the New York MVRISA), and, if not, whether the so-called "transformation rule" may be applied to deprive the purchase money portion of the obligation of its purchase money status.

Although the Bankruptcy Code does not define the term "purchase-money security interest," the interpretation of that term for purposes of the "hanging paragraph" presents a federal question. As noted previously, this federal question must be resolved by reference to the statutory text and the cramdown abuse prevention goal sought to be achieved by the enacting Congress. Moreover, Congress does not legislate in a commercial and legal vacuum – Congress is deemed to act with an awareness of pertinent existing law and its treatment of related issues.[4] The issue presented herein therefore also must be analyzed in light of the legal and commercial environment within which Congress acted – the industry practices prevailing at the time the hanging paragraph was enacted and the pre-existing laws reflecting those practices. In this instance, Congress legislated in a commercial and legal environment that featured three sets of pre-existing laws allowing for the inclusion of negative equity in motor vehicle retail Installment sale contracts – TILA and its implementing Regulation Z, state laws governing motor vehicle retail installment sales such as the New York MVRISA[5] and UCC Article 9. These three statutes, and the industry practices which they allow, informed the congressional understanding of the term "purchase-money security interest" used in the hanging paragraph.

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[4] *Goodyear Atomic Corp. v. Miller*, 486 U.S. 174, 184-85, 108 S. Ct. 1704, 1712 (1988) ("We generally presume that Congress is knowledgeable about existing law pertinent to the legislation it enacts ")

[5] Many state laws governing motor vehicle retail installment sales expressly authorize the inclusion of negative equity in a motor vehicle retail installment sale contract. *See* Addendum A (collecting state laws regulating the inclusion of negative equity in a retail installment sale contract). This brief discusses the New York MVRISA because it is the state regulatory statute applicable to Ms. Peaslee's motor vehicle retail installment sale contract.

D. The Bankruptcy Court Decision

GMAC appeals from orders of the Bankruptcy Court granting the Trustee's Valuation Motion, and overruling its objection to the confirmation of the Debtor's Plan These two orders effectively repealed one of the major amendments made by the BAPCPA by leaving GMAC exactly where it was before the BAPCPA amendments were enacted: with a secured claim reduced to the value of its collateral.

The orders appealed from are based upon a Bankruptcy Court Decision that proclaimed, in conclusory fashion, that the meaning of the "hanging paragraph" is clear – "[i]t requires that the debt included in the claim must be secured by a purchase money security interest, so that if all of the debt included in the claim is not so secured the exception provided in the Section is not applicable." 358 B.R. at 556. [6]

The court also rejected the argument that the UCC reference to "the price of the collateral" should be interpreted in light of TILA and MVRISA provisions allowing for the

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[6] The court deemed this conclusory interpretation a sensible one because it believed that a contrary ruling would undermine the policy of "equality of distribution among like creditors." This policy rationale was based upon the court's view that the negative equity included in Ms. Peaslee's motor vehicle retail installment sale contract was "refinanced unsecured negative equity debt' that was being "transformed into secured debt not supported by collateral value." *Id*.

Although believing that any inquiry into Congressional intent was "not relevant here" given its view that the text of the hanging paragraph resolved the issue, the court nevertheless stated that any attempt to discern Congressional intent "would be absurdly speculative" because it was unaware of any legislative history indicating either that Congress: (i) had specifically addressed "these transactions or even acknowledged their existence;" or (ii) "believed that the term purchase money security interest may somehow have been redefined in today's society so as to have a far different meaning than it has always been understood to have in the financial community." *Id*.

Turning its attention to the UCC definition of a purchase-money security interest, the Bankruptcy Court next stated, in conclusory fashion, that "[t]he term 'price of the collateral,' as used in Section 9-103(a)(2), has the same meaning it has always had in connection with transactions for the acquisition of any collateral, including a motor vehicle, which is the actual price of the collateral being acquired." *Id*. In support of this assertion, the court cited to a single readily distinguishable case involving collateral that had been purchased at different times in connection with different transactions and, thus, had been used to secure more than "its" price. Id. at 566 n.11 (citing *In re Manuel*, 507 F.2d 990 (5th Cir. 1975)).

inclusion of negative equity in the total sale price under a motor vehicle retail Installment sale contract. Without pausing to examine and consider carefully the related nature of those laws, the court summarily dismissed this argument with the statement that "those other statutes were not enacted in order to define or expand upon the definition of 'purchase money obligation' under the [UCC]" but were, instead, "enacted to insure adequate finance disclosure for consumer transactions or for other unrelated reasons."[7] Accordingly, the court concluded that "those statutes have absolutely nothing to do with the relative rights of creditors, as article 9 of the [UCC] and the . . . Hanging Paragraph do." *Id*. In the same vein, the court stated that it was not required to "accept the 'cash sale price' in a retail Installment contract as the equivalent of 'price of the collateral' as used in Section 9-103(a)(2)" because the underlying contract merely "indicate[s] . . . the overall 'price' of a motor vehicle acquisition transaction ***for financial disclosure purposes***." *Id.* at 557 (emphasis added).

Returning to the UCC definition of a purchase-money security interest, the court concluded that negative equity on a trade-in vehicle included in a retail Installment sale contract "is not value given 'to enable' [a] consumer to acquire rights in or the use of the replacement collateral" because "'enable' refers to what it has always referred to, which is the value given to allow the debtor to pay . . . the actual price of a new item of collateral being acquired, in these cases the replacement vehicle itself." *Id.* ("[t]hat portion of the loan provided is in fact used to pay off the lien on the trade in vehicle"). The court next addressed Official Comment 3 to UCC Section 9-103 and, without scrutinizing its text, stated, in conclusory fashion, that "paying off a consumer's negative equity in a trade-in . . . is not the kind of expense included in the price of

[7] 358 B.R. at 566-67 ("the price, however it is termed in a retail installment contract, is for the purpose of financial disclosure to the consumer, not for purposes of determining whether debt is secured by a purchase money obligation . . .").

Section 9-103(a)(2), as contemplated by Comment 3 to Section 9-103." *Id.* In so doing, the court below read into the very comment on which it relied a non-existent limitation that is nowhere to be found in the text of the Official Comment – a requirement that the "price" of the collateral include only those expenses "***that are incurred by all debtors*** acquiring similar collateral." *Id.* at 557-58 (emphasis added).

Having ruled that the negative equity debt included in the underlying retail installment sale contract was not secured by a purchase money security interest, the court considered whether a dual status rule should be employed to preserve the purchase money status of security interest in "the price" as the court conceived it. The court concluded that it was permitted, under the New York version of UCC Article 9, to adopt either a dual status rule or a transformation rule for consumer transactions in which the obligation is not entirely a "purchase money obligation." The court adopted the latter rule, stating that the adoption of a transformation rule "would best serve the interest of all the parties where there is a roll-in and refinance of [a] negative equity transaction combined with a replacement vehicle acquisition transaction." *Id.* at 560. This appeal ensued.

FACTUAL BACKGROUND

1. In August, 2004, the Debtor purchased a 2004 Pontiac Grand Am (the "vehicle") from a dealer for her personal use. Docket No. 19, ¶ 7. The selling dealer also agreed to finance her purchase under a motor vehicle retail installment sale contract. Under the installment sale contract, the seller retained a security interest in the vehicle to secure the unpaid balance of the total sale price due under the contract. The total amount financed was $23,180.00. Docket No. 59. There is no allegation that the motor vehicle retail Installment sale contract failed to comply with the principal state regulatory statute that governs motor vehicle retail installment sale transactions and the contract that evidences them -- the New York MVRISA.

2. In connection with the purchase, the Debtor traded in a 1999 Chevy Blazer which she owned. Docket No. 19, ¶ 6. At the time of her motor vehicle retail installment sale transaction, the Debtor owed $5,980 more on the trade-in vehicle than the parties agreed it was worth, requiring a pay-off of that amount to satisfy the lien on the trade-in vehicle. Docket No.

59. That amount constitutes the "negative equity" at issue in this case. Docket No. 46, p. 2.

3. The "total sale price" due under the motor vehicle retail installment sale contract included the negative equity on the trade-in, certain other items directly related to the purchase of the vehicle, and the finance charges due under the contract, as mandated by the federal Truth in Lending Act. Docket No. 59, p.5.

4. The dealer assigned the motor vehicle retail installment sale contract to GMAC, which perfected its security interest by having its lien noted on the certificate of title. Docket No. 59, p. 4.

5. The Debtor filed Chapter 13 bankruptcy on July 11, 2006, within 910 days after purchasing the vehicle. Docket No. 1.

6. GMAC filed a secured proof of claim on October 10, 2006 showing an amount of $17,904.95 due under the retail installment sale contract. No objection to GMAC's claim was filed. Docket No. 59.

7. The Debtor listed the vehicle on her schedules as having a value of $10,950. Docket No. 1, Schedule B.

8. The Debtor proposed a Chapter 13 plan seeking to modify GMAC's $17,904.95 secured claim by bifurcating it into secured and unsecured portions, based on the retail value of the vehicle at the time of the bankruptcy filing. Docket Nos. 2, 21. In addition, the Trustee filed a Motion to Value Security under §§ 506 and 1325, supporting the Debtor's proposed bifurcation of GMAC's claim. Docket No. 19.

9. GMAC objected to confirmation of the Debtor's plan on the ground that its full secured claim qualified for treatment under § 1325(a)(*), and thus could not be modified through a cramdown. Docket No. 15.

10. GMAC filed a brief opposing to the Trustee's Valuation Motion. Docket No. 37.

11. On November 15, 2006 the Bankruptcy Court heard arguments and, on December 22, 2006, entered the Order from which GMAC filed the present appeal. Docket No. 46.

12. On January 11, 2007 Judge Ninfo entered an Order confirming the Debtor's Chapter 13 Plan, Docket No. 55, from which GMAC also appeals.

13. On April 27, 2007, this Court entered a scheduling Order consolidating *Peaslee* with three other Bankruptcy Court cases involving the same issues. The Court requested that the Appellants collaborate and file a main brief (and Appellees do the same) and gave the parties the opportunity to file five-page supplemental brief with facts specific to each case. In accordance with that Scheduling Order, this is the main brief for the Appellants. However, consistent with the Scheduling Order, the factual portions of this brief address only the facts relating to the bankruptcy proceeding of Faith Ann Peaslee.

ARGUMENT

I. THE BANKRUPTCY COURT ERRED IN HOLDING THAT THE NEGATIVE EQUITY WAS NOT PART OF GMAC'S PURCHASE-MONEY SECURITY INTEREST FOR PURPOSES OF THE HANGING PARAGRAPH.

The Bankruptcy Court's December 22, 2006 decision cannot stand because GMAC's claim cannot be bifurcated into: (1) a secured claim for amounts attributable to the financing of all components of the cash price of the new vehicle except the negative equity; and (2) an unsecured claim for the negative equity component of the cash price. To do so contradicts both the plain language of the hanging paragraph and its legislative history.

A. Both the Plain Language and the Legislative History of 1325(a)(*) Support the Conclusion that Purchase-Money Security Interests in Financed Motor Vehicles are Broadly Protected from Cramdown.

In some cases of statutory construction, the plain language of the statute is at odds with the legislative purpose. This is not such a case. Both the letter and the spirit of the Bankruptcy Code point toward the conclusion that cramdown is prohibited when negative equity on the consumer's trade-in vehicle is financed as part of the cash price of the new vehicle. A review of the plain language of Section 1325(a)(*), together with its legislative history, shows that in enacting the hanging paragraph Congress intended to prevent ***any*** cramdown of the claims of purchase-money vehicle financers.

i. The plain language of the Bankruptcy Code contemplates negative equity financing.

The lower court purports to interpret the plain meaning of the hanging paragraph to conclude that negative equity cannot be included in GMAC's purchase-money security interest because to do so would transform an unsecured claim into a secured claim. Docket No. 46, p. 7.

The Bankruptcy Court saw no absurdity in applying new legislation – designed by Congress to enhance the rights of motor vehicle financers – to put GMAC in exactly same place it would have been prior to the enactment of BAPCPA. The Bankruptcy Court's conclusion is contrary to the plain language of the statute and does violence to Congress' intent.[8]

Section 1325(a)(*) provides as follows:

> For purposes of paragraph (5), section 506 shall not apply to a claim described in that paragraph if the creditor has a purchase-money security interest securing the debt that is the subject of the claim, the debt was incurred within the 910-day [*sic*] preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle (as defined in section 30102 of title 49) acquired for the personal use of the debtor, or if collateral for that debt consists of any other thing of value, if the debt was incurred during the 1-year period preceding that filing.

The text of Section 1325(a)(*) is clear. The statute prohibits the bifurcation of any claim coming within its scope. Its language is broad, absolute and unqualified; the statute contains no exceptions or limitations nor does it require that the vehicle secure only a portion of its purchase price in order to qualify for the protection against cramdown. For example, the statute contains no language limiting the benefit that it confers "to the extent" of a purchase-money security interest. To the contrary, the statute requires only that a purchase-money security interest exist -- it applies "***if*** the creditor has a purchase-money security interest securing the debt that is the subject of the claim." (emphasis added.) The statute therefore must be read to prevent ***any*** cramdown. Courts interpreting the statute have found that it means just what it says -- the value

[8] "The starting point in discerning congressional intent . . . . is the existing statutory text . . . and not the predecessor statutes." *Lamie v. United States Trustee*, 540 U.S. 526, 534 (2004) (internal citation omitted). Where the statute is clear, "the sole function of the courts – at least where the disposition required by the text is not absurd – is to enforce it according to its terms." *Id*., citing *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) (citations omitted).

of the collateral is irrelevant in determining the allowed amount of the secured claim.[9]

That Congress did not intend that Section 1325 be limited to transactions involving the financing of ***only*** a portion of the purchase price of the motor vehicle is also evident when Section 1325 is contrasted with other Bankruptcy Code sections. For example, Section 1322(b), which grants protection against bifurcation of residential mortgages, provides that, "[a] plan may modify the rights of holders of secured claims, other than a claim secured *only by* a security interest in real property that is the debtor's principal residence . . ." (emphasis added). Cases interpreting that section hold that it requires that a creditor be secured ***only*** by a mortgage in order to gain the protections of that section. *See e.g., In re Hughes*, 333 B.R. 360, 363-64 (Bankr. M.D.N.C. 2005).

This difference is significant because, in enacting Section 1322(b), Congress was clear that the protection against modification of the secured claim was available ***only*** if the claim was secured solely by the debtor's residence. When Congress intended such a limitation, it knew how to provide for it by using the word "only." If Congress had intended for motor vehicle financing to get the protection of Section 1325(a)(*) only for a portion of the purchase price of the vehicle, it would have said so in the statute. It did not.

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[9] *See e.g.*, *In re Fleming*, 339 B.R. 716, 722 (Bankr. E.D. Mo. 2006) ("The value of the collateral is irrelevant in determining the allowed amount of the secured claim."); *In re Robinson*, 338 B.R. 70, 73-74 (Bankr. W.D. Mo. 2006) ("[t]hese creditors are entitled to secured claims for the total amount of their claims, regardless of the value of the respective vehicles, and the Debtor cannot bifurcate them."); *In re Hill*, 328 B.R. 490, 508 n. 20 (Bankr. S.D.Tex. 2005) (". . . in revised § 1325(a), § 506 no longer applies to purchase-money secured debts on motor vehicles that are less than 910 days (about 2 ½ years)."); *In re Brown*, 339 B.R. 818, 820 (Bankr. S.D. Ga. 2006) ("[T]he [910 Language] means only that the claims it describes cannot be bifurcated into secured and unsecured portions under § 506(a)."); *In re Turner,* 349 B.R. 437, 442 (Bankr. D.S.C. 2006) (holding that hanging paragraph prevents any stripping down in chapter 13 and that secured creditors subject to § 1325(a) "are fully secured for the entire amount of their claims and must be repaid in full through a Chapter 13 plan if the debtors wish to retain the collateral securing the claim.").

The legislative history supports a ban on cramdown that covers the ***entire purchase price*** of the new vehicle. To the extent the Court may believe that the language of Section 1325(a)(*) is not clear on its face, prior versions of proposed bankruptcy reform legislation show that Congress' intent in enacting BAPCPA was to prohibit any cramdown of this type of claim. Legislation proposed prior to the enactment of BAPCPA demonstrates that limitations on the protections to be afforded to secured creditors were considered, but ultimately rejected, by Congress.[10] Had Congress intended for the Section 1325(a)(*) protections from cramdown to be limited to the purchase-money obligation for only a portion of the purchase price of the vehicle, it would have said so in the statute.[11] Instead, Congress simply chose to say that Section 506 does not apply "if the creditor has a purchase-money security interest securing the debt that is the

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[10] For example, section 128 of House Bill 3150, entitled "Restraining Abusive Purchases on Secured Credit," proposed special protections to be afforded secured creditors in a revised Section 506 rather than in Section 1325(a). The proposed amendment to Section 506(e)(3) would have specifically limited the secured creditor's protection from bifurcation to the "purchase price" of the personal property acquired, and would have excluded protection for obligations attributable to other related items. Specifically, the proposed amendment, which Congress rejected, reads as follows:

> Section 506 of title 11, United States Code, is amended by adding at the end the following: (e) In an individual case under chapter 7, 11, 12 or 13 . . .
>
> (3) if such allowed claim attributable to the purchase price is secured by the personal property so acquired and other property, the value of the security may be determined under subsection (a), but the value of the security and the amount of the allowed secured claim shall be not less than the unpaid principal balance of the purchase price ***of the personal property acquired*** and unpaid interest and charges at the contract rate . . .

Bankruptcy Reform Act of 1998, H.R. 3150, 105th Cong. § 128 (1998) (emphasis added).

The fact that Congress rejected legislation that would have limited the scope of the cramdown proscription to the portion of the debt attributable to the purchase price of the property acquired supports the conclusion that Congress did not intend to place any such limitation on the BAPCPA protection from bifurcation.

[11] *See e.g. In re Bufford,* 2006 WL 1677160, *9 (Bankr. N.D. Tex.) (in evaluating whether *Till* was overruled, by then enactment of BAPCPA, the court stated that "[t]he ruling in *Till* must certainly have

subject of the claim . . .."

The Bankruptcy Court decision expresses concern that motor vehicle financers would be permitted to transform unsecured credit into secured credit, to the extent of negative equity, when a debtor files bankruptcy. But the debt on the trade-in vehicle didn't start off as unsecured debt; it was secured purchase money debt. The negative equity resulted from a variance between the rates of amortization and depreciation – the unpaid balance under the prior motor vehicle credit agreement amortized at a rate less than the rate at which the trade-in vehicle depreciated. Protecting all that purchase-money debt is the exact remedy Congress intended in order to stem the abusive use of cramdown by consumers, as reflected in the legislative history.

In a recent decision, the Bankruptcy Court for the Eastern District of Michigan rejected precisely this "transforming unsecured credit into secured credit" argument. The argument was raised by a debtor trying to bifurcate a claim under the hanging paragraph in *In re Honeycutt*, Case No. 06-48771, November 2, 2006, (oral opinion, transcript attached as Addendum B). The debtor in that case argued that "the creditor will have effectively used subterfuge to turn a potential unsecured debt, the lease deficiency, into a fully secured purchase-money security interest debt." *Honeycutt* transcript, p. 12 (discussed infra). The Michigan bankruptcy court dismissed this argument as "nothing short of ridiculous. First, it presumes a fact pattern which does not exist. Second, it implies that Ford coerced the debtor into terminating her lease and purchasing a new vehicle as part of a grand pre-bankruptcy planning scheme designed to injure debtors." *Id.* at 12-13. Similarly, the Bankruptcy Court erred in bifurcating GMAC's claim under the hanging paragraph.

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been on the minds of the drafters of BAPCPA, being handed down from the Supreme Court less than one year prior to its enactment, and yet Congress chose not to address it.").

ii. Congress was well aware of industry practice of including "negative equity" for trade-in vehicles as part of new-car purchase-money financings.

The Bankruptcy Court's decision also is contrary to the industry practice prevailing at the time Congress enacted the hanging paragraph. The practice of rolling negative equity from a trade-in into the purchase price of a new car is common in the automobile finance industry, and in fact is discussed in FDIC materials and Federal Reserve Board Staff Interpretations of federal law. Given the prevalence of the practice in the industry, it is illogical to presume – as the Bankruptcy Court did -- that Congress did not intend for the protection afforded by Section 1325(a)(*) to extend to negative equity.

Consumers owning a car often find themselves "upside down" on their motor vehicle financing. In other words, they owe more on the financing secured by the vehicle than its value. *See, e.g.*, *In re Hill*, 328 B.R. 490, 507 (Bankr. S.D. Tex. 2005) ("It is quite common, from this Court's experience, that a debtor's car note is (often substantially) higher than the value of the vehicle."). When a car owner is in a negative-equity position and decides to purchase a new car, typically he or she will request the seller of the new car to finance the negative equity in the old car as part of the retail Installment sale transaction. If that package deal is agreed to, the seller will finance payment of the negative equity and roll that amount into the price of the new car. *See In re Brown*, 170 B.R. 362, 366 (Bankr. S.D. Ohio 1994). To make the purchase of the new vehicle practicable, the old financing on the trade-in must be paid off. This practice of rolling negative equity from a trade-in into the purchase price of a new car is common in the industry. In fact, it has been estimated that 38 percent of new car buyers have negative equity at trade-in.[12]

[12] *See e.g.*, FDIC Supervisory Insights, *The Changing Landscape of Indirect Automobile Lending*, June 23, 2005 ("J.D. Power and Associates estimates that approximately 38 percent of new car buyers have negative equity at trade-in, compared to 25 percent two years ago.").

If Congress had intended to preclude cramdown protection for such a recurrent feature of motor vehicle financing, it surely would have said so in the statute.

Purchase-money security interests are not given preferred status to benefit only the creditor. "Rather, (t)he purchase-money priority rule encourages the acquisition of new assets by the debtor . . ."[13] In that regard, the Bankruptcy Court's "plain language" interpretation creates an absurd result because it would not make sense for the Bankruptcy Code to encourage vehicle sales by protecting the car financer's purchase-money security interest while simultaneously taking that protection away when the debtor is aided, at his or her own request, in acquiring new assets by paying off the trade-in debt. The Bankruptcy Court recognized that the practice of rolling in negative equity is "good for both parties," Docket No. 46 p. 24, yet its decision will surely chill these types of transactions. If purchase-money status is lost for negative equity, the sale will be discouraged rather than encouraged, and the policy of purchase-money protection will be undermined.

iii. Congress knew that the Federal Truth in Lending Act links purchase-money financing of new cars and negative equity for trade-ins.

When Congress enacted the BAPCPA in 2005, it is presumed to have known about other pertinent federal law governing purchase-money financing of motor vehicles.[14] One such important law is TILA, 15 U.S.C. § 1600 *et seq.*, as implemented by Federal Reserve Board Regulation Z (12 C.F.R. Part 226). In 1999, the Federal Reserve Board adopted an Official Staff Interpretation of Regulation Z that included guidance on how purchase-money vehicle financers

[13] *In re Gibson*, 16 B.R. 257, 265 (Bankr. D. Kan. 1981), citing Gerald T. McLaughlin, "*Add On" Clause in Equipment Purchase-money Financing: Too Much of a Good Thing,* 49 Fordham L. Rev. 661, 670-71 (1981).

[14] *See Quality Tooling v. United States*, 47 F.3d 1569, 1584 (Fed. Cir. 1995) ("When Congress enacts legislation, it is presumed to know the pertinent law.") (citations omitted)

should treat negative equity for TILA disclosure purposes. 64 Fed. Reg. 16614-01, 16617.[15] This Official Staff Interpretation required that negative equity be disclosed as part of the "total sale price" because the "total sale price" is affected by the inclusion of negative equity. Accordingly, TILA – the principal federal consumer credit protection law applicable to the transaction at issue – recognizes that the cash sale price of the vehicle is linked with the negative equity as part of a single financing transaction.

TILA was enacted to "promote the informed use of consumer credit by requiring disclosures about its terms and cost." 12 C.F.R. § 226.1(b) (2007). TILA requires a creditor extending "closed end credit" to a consumer debtor to disclose the "total sale price" of the "property or services." 15 U.S.C. § 1638(a)(7). Federal Reserve Board Regulation Z, which implements TILA,[16] defines the term "total sale price" to include the "sum of the cash price, the items described in paragraph (b)(2),[17] and the finance charge disclosed under paragraph (d) of this section." 12 C.F.R. § 226.18(j) (2007). Notably, negative equity from a trade-in is included ***in the "total sale price"*** disclosed to the consumer.[18] Thus, TILA recognizes that the amount of motor vehicle financing given to satisfy a negative equity obligation from a prior financing is

[15] The Official Staff Interpretation of Regulation Z adopted by the FRB contained the following guidance with respect to the treatment of negative equity: "[W]hen a credit sale transaction involves property that is being used as a trade-in (an automobile, for example) and that has a lien exceeding the value of the trade-in, ***the total sale price is affected by the amount of cash provided***. . . . To illustrate, assume a consumer finances the purchase of an automobile with a cash price of $20,000. Another vehicle used as a trade-in has a value of $8,000 but has an existing lien of $10,000, leaving a $2,000 deficit that the consumer must finance. . . . ***In that case, the total sale price would include the*** sum of the $20,000 cash price [and] the ***$2,000 lien payoff amount as an additional amount financed*** . . . ". 12 C.F.R. Part 226, Supp. I, ¶ 18(j)-3, at 464 (emphasis added).

[16] Federal Reserve Board Regulation Z, 12 C.F.R. Part 226 (2007).

[17] 12 C.F.R. § 226.18(b)(2); *see* 12 C.F.R. Part 226, Supp. I, ¶ 18(b)(2)-1, at 458 (Official Staff Interpretation requiring that "[f]ees and other charges that are not part of the finance charge and that are financed rather than paid separately at consummation of the transaction [be] included in the amount financed.").

[18] *See* 12 C.F.R. Part 226, Supp. I, ¶ 18(j)-3, at 464; note 17 *supra*.

part of the purchase money financing package – the "total sale price" -- for the vehicle.

Moreover, TILA considers a financing to be a purchase-money transaction even if only part of the proceeds are used to purchase the collateral. In connection with an extension of closed end credit, TILA requires that the creditor disclose whether it "[h]as or will acquire a security interest in the property purchased as part of the transaction, or in other property identified by item or type." 12 C.F.R. § 226.18(m). The official staff interpretations of this security interest disclosure requirement describe "purchase-money transactions" as transactions in which "the collateral is the item purchased ***as part of***, or with the proceeds of, ***the credit transaction***. . ."[19] The official staff interpretations further provide that "[a]ny transaction in which the credit is being used to purchase the collateral is considered a purchase-money transaction . . ." *Id.*

In short, a vehicle financing is considered to be a purchase-money transaction for TILA disclosure purposes even though part of the proceeds are used to satisfy the remaining debt owing on the trade-in vehicle. By treating negative equity as part of the "total sales price," TILA links it to the cash price and treats both items as part of a single purchase-money financing.

B. In Amending Section 1325 of the Bankruptcy Code, Congress Was Aware of the U.C.C. Definition of "Purchase-Money Security Interest," Which Includes Negative Equity.

Because the term "purchase-money security interest" used in the hanging paragraph is not defined in the Bankruptcy Code, courts appropriately have looked to Revised Article 9 of the UCC and state laws governing motor vehicle retail installment sales for guidance in interpreting the meaning of Section 1325(a)(*). *In re Graupner*, 356 B.R. 907 (Bankr. M.D. Ga. 2006).

[19] 12 C.F.R. Part 226, Supp. I, ¶ 18(m)-1, at 465-66 (2007).

Section 9-103 of the UCC provides that "a security interest in goods is a purchase-money security interest . . . to the extent that the goods are purchase-money collateral with respect to that security interest." It defines "purchase-money collateral" as "goods . . . that secur[e] a purchase-money obligation incurred with respect to that collateral." A "purchase-money obligation" is defined, in turn, as "an obligation of an obligor incurred as all or part of the price of the collateral or for value given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used." (*See, e.g.*, N.Y. U.C.C. Law § 9-103 (McKinney 2006), which is essentially identical to the uniform version.) In short, the focus of the UCC definition of a PMSI is on the purchase-money "obligation" that is secured by the collateral. Like the federal statute itself, the UCC definition of a "purchase-money obligation" clearly encompasses the negative equity component of a motor vehicle retail installment sale.

The UCC definition of "purchase-money obligation" contains two prongs: (i) ***the price of the collateral***; and (ii) ***any value given to enable the debtor to buy the collateral.*** The two prongs are alternatives; GMAC prevails if it satisfies either prong. In this case, ***both*** prongs support the inclusion of negative equity as part of the purchase-money obligation.

i. Under the first prong of the UCC definition, the "price" of the new vehicle purchased by the debtor in this case includes the "negative equity" from the trade-in.

Although the UCC Section 9-103 does not define the "price" of the collateral, the statute does not use a limiting adjective or a narrow term such as "cash price." As evidenced by the Official Comment references to finance charges and collection costs, the statutory reference to the "price" contemplates a credit sale transaction – an installment sale for a time sale price that includes a finance charge for the privilege of paying in installments. *See, e.g.*, N.Y. U.C.C. § 9-103 Comment 3 (McKinney 2006). Moreover, the Official Comments to UCC Section 9-103

contain an illustrative list of the types of obligations and expenses that are included with the "price" of collateral and the "value given to enable" the debtor to make the purchase:

> [t]he 'price' of collateral or the 'value given to enable' includes ***obligations for expenses incurred in connection with acquiring rights in the collateral***, sales taxes, duties, finance charges, interest freight charges, costs of storage in transit, demurrage, administrative charges, expenses of collection and enforcement, attorney's fees, and other similar obligations.

Id. § 9-103 Comment 3 (emphasis added). Negative equity with respect to a trade-in vehicle plainly constitutes an "obligation[] for [an] expense[] incurred in connection with acquiring rights in the collateral" and, hence, part of the "price" of the collateral.

The Bankruptcy Court decision avoided this self-evident conclusion by distorting, and effectively rewriting, the language of this Official Comment. Although the Bankruptcy Court correctly quoted Comment 3 in a footnote to its Decision and Order, it made no attempt to parse its way through the language of the Official Comment. *See Peaslee*, 358 B.R. at 557-58 & n.13; *see generally Graham v. United States*, 96 F.3d 446, 450 (9th Cir. 1996) (statutory 'interpretation . . . is a process whereby we figure out the meaning of the words that actually are there") (Kozinski, J., dissenting). The Bankruptcy Court proceeded instead simply to announce, in the text accompanying the footnote, its conclusion that "paying off a consumer's negative equity in a trade-in . . . is not the kind of expense included in the price of Section 9-103(a)(2), as contemplated by Comment 3 to Section 9-103." 358 B.R. at 557-58. The Bankruptcy Court then proffered the following explanation for its conclusion:

> The roll-in and refinance of negative equity . . . *is not the kind of incidental and directly related expense*, ***such as*** *taxes and license and registration fees*, contemplated by Comment 3, especially when the negative equity can be $10,000 . . . or more. . . . the majority of consumers purchasing motor vehicles do not have to roll-in and refinance negative equity in a trade in, so ***electing to do that does not make it the kind of expense that would be 'similar' to those expenses***

> ***enumerated in Comment 3 to Section 9-103 that are incurred by all debtors*** acquiring similar collateral.

Id. (emphasis added and footnote omitted). This reasoning contradicts the express language of Comment 3, which plainly states that "obligations for expenses incurred in connection with acquiring rights in the collateral" is one of ten ***separate and independent*** types of obligations that might be part of the price of the collateral or the value given to enable its acquisition.

As a result of its failure to discern that "obligations for expenses incurred in connection with acquiring rights in the collateral" is an independent example of "price" and "value to enable," the Bankruptcy Court has effectively rewritten Comment 3 to impose a requirement that a purchase money obligation be one, "such as" vehicle title, license and registration fees, that is incurred "by all debtors acquiring similar collateral." Yet such a limitation that is nowhere to be found in Comment 3's illustrative list of purchase money obligations and, indeed, is wholly inconsistent with its language stating that the "price" or "value given to enable" includes "***obligations for expenses incurred in connection with acquiring rights in the collateral***, . . . and other similar obligations." Simply stated, the Bankruptcy Court failed to acknowledge the independent nature of this example of a purchase money obligation and, instead, effectively rewrote the Comment to read as follows -- "[t]he 'price' of collateral or the 'value given to enable' includes obligations for expenses incurred in connection with acquiring rights in the collateral ["such as"], sales taxes, duties, finance charges, expenses of collection and enforcement, attorney's fees, and other similar obligations." *See id*. at 557-58. Accordingly, the decision of the Bankruptcy Court rests ultimately upon a rationale that is plainly at odds with the very Official Comment that the Bankruptcy Court invoked to justify its conclusion.

Having erected an edifice upon a non-existent foundation, the Bankruptcy Court avoided

the need to explain how one could conclude that the portion of the new secured debt attributable to the inclusion of the negative equity balance is not clearly an "obligation for expenses incurred [payoff of the prior lien holder] in connection with acquiring rights in the collateral [the new vehicle]." In fact, the expansive notion of "price" found in the Comment fits the negative equity at issue in this case like a glove. In two recent bankruptcy court decisions -- one from Michigan and one from Georgia -- the courts relied heavily upon the "expenses incurred in acquiring rights" language of Comment 3 in holding that negative equity was part of a protected purchase-money obligation. [20] This Official Comment should be given great weight, particularly when the statutory text does not define the "price" of the collateral and the Comment, properly construed, is in accord with the treatment of negative equity in other statutes applicable to the retail Installment sale transaction – TILA and state laws governing motor vehicle retail installment sales such as the MVRISA.[21] *See* Section I. A.iii *supra*; Section I.B.ii *infra*.

Indeed, the Official Comment discussion of items that the "price" includes must be so construed in order to avoid rendering the Comment internally inconsistent. The Official Comment invoked by the Bankruptcy Court is comprised of two paragraphs, the second of which reads as follows:

> The concept of 'purchase money security interest' requires ***a close nexus between the acquisition of collateral and the secured obligation***. Thus, a security interest does not qualify as a purchase-money security interest if a debtor acquires

[20] *In re Honeycutt*, Case No. 06-48771 (Bankr. E.D. Mich. 11/2/06), written transcript, pp. 6-7, attached hereto as Addendum B; *In re Graupner*, 356 B.R. 907 (Bankr. M.D. Ga. 2006).

[21] *See e.g., Fidelity & Deposit Co. of Md. v. Chemical Bank New York Trust Co.*, 309 N.Y.S.2d 266, 272 (N.Y. Civ. Ct.), *rev'd on other grounds, Fidelity & Deposit Co. of Maryland v. Chemical Bank New York Trust Co.*, 318 N.Y.S. 2d 957 (N.Y. Sup. Ct. 1970), ("The foregoing [Official Comment] is entitled to great weight in interpreting the statute in the absence of specific language to the contrary."); *In re Yale Exp. System, Inc.*, 370 F.2d 433, 437 (2d Cir. 1966). ("The 'Official Comments' of the Code are, of course, not binding on a federal court . . . . But, they are powerful dicta . . . and [are], therefore, as we have noted, a most appropriate source of federal law.").

> property on unsecured credit and subsequently creates the security interest to secure the purchase price.

E.g., N.Y. U.C.C. § 9-103 Comment 3 (emphasis added). It is this paragraph of Comment 3 that sets forth the standard that must be satisfied in order for the security interest to qualify as a purchase-money interest. This "close nexus" standard is a liberal one – all that it requires is a close connection between the acquisition of the vehicle and the secured obligation. GMAC respectfully submits that one can not credibly contend that there is not such a close connection when the negative equity with respect to a trade-in vehicle is paid off by the seller of the new vehicle as part of its retail installment sale of the new vehicle and the related obligation is included its retail installment sale contract with the buyer.

ii State Laws like the New York Motor Vehicle Retail Instalment Sales Act, which expressly authorize the inclusion of negative equity in a motor vehicle retail Installment sale contract, confirm the definition of "price" found in the UCC.

The Bankruptcy Court summarily dismissed the New York MVRISA as a mere "disclosure" statute that was irrelevant to its interpretation of UCC Section 9-103, but that conclusory assertion does not withstand minimal scrutiny. While the MVRISA imposes certain disclosure requirements, the disclosure requirements applicable to a motor vehicle retail installment sale transaction are principally the province of TILA. *See, e.g.*, N.Y. Pers. Prop. Law § 302(5) (McKinney Supp. 2007) (MVRISA provision requiring that a retail installment contract contain "[a]ll items required to be disclosed by the act of congress entitled "Truth in Lending Act," and the regulations thereunder, as such act and regulations may from time to time be amended").[22] Contrary to the lower court's assumption, the New York MVRISA is ***not*** primarily a disclosure statute. The MVRISA is the principal New York State regulatory statute governing

motor vehicle retail installment sales and, consequently, it contains numerous substantive provisions regulating almost every aspect of such Installment sales and the contracts that evidence them.[23] Indeed, GMAC potentially could be subject to severe penalties if it purchased a motor vehicle retail installment sale contract that failed to comply with the MVRISA. *See* N.Y. Pers. Prop. Law § 307 (McKinney 1992).

Dealer financing of motor vehicles is archetypal "purchase-money financing" because the original financer is the seller of the collateral. The primary purpose of the New York MVRISA is to serve as comprehensive ***regulatory*** legislation. It authorizes dealer financing of motor vehicles, but only if the financing is part of a purchase-money package – a "retail instalment sale" of a motor vehicle that is memorialized in a "retail instalment contract." *See* N.Y. Pers. Prop. Law §§ 301(4), (5). Sales finance companies, such as GMAC, purchase such retail installment sale contracts from the motor vehicle dealers who entered into them with retail buyers. *Id.* §§ 301(9), 302(10). Consequently, the installment sale contracts purchased by GMAC are subject to extensive substantive regulation under the MVRISA.

One of the principal limitations imposed by the MVRISA is a restriction on what items

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[22] A copy of the entire New York MVRISA is attached as Addendum C.

[23] The New York MVRISA contains provisions governing the types of insurance that may be offered by the dealer (§ 302(6)); regulating the force placement of insurance on the vehicle (§ 302(6-a)); regulating delinquency and collection charges (§ 302(7)); prohibiting blank spaces in the contract (§ 302(8)); prohibiting waivers of claims or defenses (§ 302(9)); authorizing a "financing agency," such as GMAC, to purchase an instalment sale contract for such price as may be mutually agreed upon (§ 302(10)); requiring that, upon written request, the holder of the contract provide a written statement of the payoff amount (§ 302(12)); limiting acceleration clauses and repossession; prohibition of "confession of judgment" provisions, consumer waivers, and seller/assignee disclaimers of liability; protection of the buyer's right of redemption (§ 302(13)); regulating "gap" insurance (§ 302A); limiting credit service charges (*i.e.*, finance charges) (§ 303); requiring evidence of payment in full (§ 304); prohibiting any penalty for prepayment (§ 305); regulating refinancing (§ 306); requiring refund credit for cancellation of insurance (§ 312); limiting guaranties of the buyer's obligation (§ 313); limiting deficiencies (§ 315); and requiring notice of buyer's redemption rights (§ 316). In short, the MVRISA comprehensively regulates motor vehicle financing by dealers and "financing agencies," such as GMAC, that purchase motor vehicle retail instalment sale contracts between retail sellers (*i.e.*, motor vehicle dealers) and retail buyers.

may be included in the purchase-money package that is denominated a "retail Installment sale" transaction. Consistent with the UCC notion of a purchase-money obligation in which there is a "close nexus" between the secured obligation and the purchase of the collateral, the MVRISA reflects a public policy against including in a retail installment sale contract any debt that is not directly related to the purchase of a motor vehicle. This limitation on what may be financed in connection with a retail installment sale is reflected in the MVRISA provision limiting the finance charge that may be imposed under a retail Installment sale contract, which provides as follows:

> The credit service charge[24] authorized by this subdivision ***shall be computed on an amount equal to*** the total of the difference between the cash sale price of the motor vehicle and the amount of the buyer's downpayment and the amount of official fees , and such charge as may be made on an amount included in the contract for insurance as determined under . . . this chapter.

Id. § 303(1) (emphasis added); *accord id.* § 303(4) (alternative provision authorizing "a credit service charge calculated upon the unpaid balances of" this amount). "No [other] fee, expense or other charge whatsoever shall be taken, received, reserved or contracted for except as provided in" specified sections of the MVRISA. *Id.* § 303(5) (McKinney Supp. 2007). Consequently, contrary to the Bankruptcy Court's conclusory assertion that the MVRISA is merely an irrelevant disclosure statute, it actually serves to define statutorily the permissible contours of the purchase-money package that is a "retail instalment sale."[25]

Viewed against this regulatory backdrop, it becomes abundantly clear that the

[24] The "credit service charge" is the term used in the New York MVRISA to denote the finance charge. *See* N.Y. Pers. Prop. Law § 301(8) (McKinney Supp. 2007).

[25] These MVRISA restrictions prevent a dealer from including in a retail installment sale contract amounts unrelated to the sale of the vehicle such as the payoff of a prior obligation with respect to unrelated consumer goods or additional funds for the consumer to use for unrelated purposes.

MVRISA definition of the "cash sale price" is ***directly*** relevant to the issue of how a motor vehicle "purchase-money obligation" has been defined by the State of New York. As GMAC noted in the court below, the MVRISA defines the "cash sale price" in a manner that treats negative equity and certain other closely related items (such as extended warranties) as part of the purchase-money package:

> "Cash sale price" means the cash sale price stated in instalment contract for which the seller would sell to the buyer, and the buyer would buy from the seller, the motor vehicle which is the subject matter of the retail instalment contract if the sale were a sale for cash instead of a retail Installment sale. The cash sale price may include any taxes, registration, license and other fees and charges for insurance, for accessories and their installation and for delivering, servicing, repairing or improving the motor vehicle and for other services incidental to the agreement. ***It also may include the unpaid balance of any amount financed under an outstanding motor vehicle loan agreement or motor vehicle retail instalment contract or the unpaid portion of the early termination obligation under an outstanding motor vehicle retail lease agreement.***

N.Y. Pers. Prop. Law § 301(6) (McKinney Supp. 2006) (emphasis added). The underscored definitional language expressly authorizes a dealer to increase the price of the vehicle being sold to cover the amount expended by the dealer to satisfy the negative equity in the trade-in vehicle. The New York MVRISA and its "cash sale price" definition thus confirm the broad treatment of "price," and the notion of a "close nexus," found in Comment 3 to UCC Section 9-103

It is evident from the foregoing discussion that the New York MVRISA and UCC Section 9-103 are related statutes governing the same subject -- retail installment sale transactions – and that the latter statute should be interpreted in a manner that harmonizes it with the former statute. The MVRISA defines a "retail instalment contract" as an agreement pursuant to which the retail seller takes a security interest in a motor vehicle which is the subject matter of a retail instalment sale. *Id*. § 301(5). Indeed, in certain instances the MVRISA actually cross-references related

provisions of UCC Article 9.[26] Conversely, the UCC acknowledges the relationship between Article 9 and regulatory laws such as the MVRISA. An Official Comment provides that UCC Section 9-201 "makes clear that certain transactions, although subject to this Article [9], also are subject to other applicable laws relating to consumers" and "that the other law is controlling in the event of a conflict . . .." *E.g.*, N.Y. U.C.C. § 9-201, cmt. 3; *accord id.* § 9-201(b), (c). Moreover, the New York UCC also provides that "shall" it be supplemented by principles of law and equity. *Id.* § 1-103. The Official Comments to the Revised Article 1 counterpart to this New York UCC Section acknowledge that "[t]here are a growing number of state statutes addressing specific issues that come within the scope of the Uniform Commercial Code" and that "[w]hen the other law relating to a matter within the scope of the [UCC] is a statute, ***the principles of [supplementation] remain relevant to the court's analysis of the relationship between that statute and the [UCC]***, but other principles of statutory interpretation that specifically address the interrelationship between statutes will be relevant as well." Revised UCC Section 1-103, cmt. 3 (emphasis added).

A fundamental principle of statutory construction merely serves to confirm the inter-related nature of the two statutes and the need to take the MVRISA definition of the "cash sale price" into account when construing UCC Section 9-103. "In accordance with general rules of construction, statutes which are *in pari materia* are to be construed together as though forming part of the same statute." N.Y. Stat. Law § 221(b) (McKinney 1971). Statutes such as the MVRISA and UCC Section 9-103 relate to the same subject matter and, hence, are deemed to be

[26] *See* N.Y. Pers. Prop. Law §§ 315 (regulating what happens "if a buyer defaults on any instalment of the time sale price and the holder obtains possession of the motor vehicle and disposes it as provided in §9-610 of the Uniform Commercial Code . . . ."); 316 (setting forth requirements with respect to a redemption notice if "[t]he holder of any motor vehicle instalment contract . . . repossesses or accepts a voluntary surrender of a motor vehicle pursuant to . . article nine of the uniform commercial code . . .").

in pari materia with one another. *Id.* § 221(a). Section 9-103 of the UCC deals generally with the subject of a purchase-money security interest in goods, while the MVRISA regulates the permissible contents of a particular type of purchase-money security agreement – a purchase-money financing package that is memorialized in a motor vehicle retail installment contract. The statutes are *in pari materia* because the former includes the latter and the statutes therefore relate to the same subject -- the installment sale financing of motor vehicles.

Being *in pari materia*, the UCC Section 9-103 reference to the "price" of the collateral, and the MVRISA definition of the "cash sale price" of a motor vehicle, must be harmonized and construed together as though they were part of the same statute. In the context of a motor vehicle retail installment sale, any item includable within the MVRISA definition of the "cash sale price" must be includable within the "price" of the collateral for purposes of UCC Section 9-103. This interpretative approach makes perfect sense because an absurd result could obtain if the two terms were interpreted as if they were unrelated to one another. *See* N.Y. Stat. Law § 145 (McKinney 1971) ("[a] construction which would make a statute absurd will be rejected"). For example, it would make no sense to conclude, as the Bankruptcy Court implicitly did, that the New York legislature defined the term "cash sale price" to allow the inclusion of negative equity in a purchase-money financing package while inconsistently contemplating a more restrictive definition of "the price" of the collateral that would preclude a secured creditor who included such negative equity in its installment sale contract from obtaining a purchase-money security interest.

As evidenced by the chart attached hereto as Addendum A, 35 other states expressly authorize the inclusion of negative equity in a motor vehicle retail Installment sale contract. The laws of these 35 other states, like the New York MVRISA, expressly permit this longstanding

industry practice and reflect a public policy consensus on the state legislative level in favor of the inclusion of negative equity, in the purchase-money package that is a retail installment sale, as a means of facilitating financed sales of new vehicles. It would do violence to the maxim that Congress is presumed to know the law, and to the reality that Congress does not legislate in a commercial and legal vacuum, for a court to assume that a public policy and legal regulatory regime that was so well-established at the state level was to be treated as a nullity for purposes of this interpretive exercise.

Appreciating the relevance and the inter-related nature of state regulatory laws like the New York MVRISA, two of the bankruptcy courts that have protected negative equity as part of a purchase-money security interest under Section 1325(a)(*) and UCC Section 9-103 have done so in reliance upon the definition of "price" contained in a motor vehicle retail installment sales statute. In *In re Graupner* 356 B.R. 907 (Bankr. M.D. Ga. 2006), the Bankruptcy Court for the Middle District of Georgia held "that under Georgia law, in the context of the sale of a motor vehicle in accordance with Georgia's Motor Vehicle Sales Financing Act, the term 'price' as used in Georgia's definition of 'purchase-money security interest,' includes any amount paid to satisfy a security interest in Debtor's vehicle used as a trade-in." The *Graupner* court thus properly construed the two statutes *in pari materia*. Similarly, the Bankruptcy Court for the Eastern District of Michigan, in its oral decision in *In re Honeycutt* (*supra*), stated "that under the Michigan Motor Vehicle Sales Finance Act, Mich. Comp. Laws § 492.101, negative equity in a trade-in or balance owed on a lease are by definition expenses incurred in connection with purchasing the collateral." *In re Honeycutt*, p. 8, ln. 14 – 19.

In sum, when Congress enacted the hanging paragraph to prevent abusive cramdowns by debtors, it did so against a backdrop of pre-existing commercial law and prevailing industry

practice. *See, e.g.*, N.Y. Stat. Law § 127 (McKinney 1971) ("In the construction of statutes, consideration may be given to usage and custom as indicative of practical construction or as constituting a part of the circumstances surrounding the enactment of the statute"); N.Y. U.C.C. §§ 1-102(1), (2) (the UCC "shall be liberally construed and applied to promote its underlying purposes and policies" one of which is "to permit the continued expansion of commercial practices through custom, usage and agreement of the parties"). The prevailing industry practice was reflected in three sources of pre-existing commercial law addressing the purchase-money financing of motor vehicles: (1) the federal Truth in Lending Act; (2) state laws governing motor vehicle retail installment sales such as the New York MVRISA; and (3) Article 9 of the UCC. All three of these pre-existing statutes treat negative equity as part of the purchase-money obligation incurred in connection with a motor vehicle retail installment sale. These three statutes, and the industry practices they sanction, informed congressional understanding of the term "purchase-money security interest" that it used in the hanging paragraph.

iii. Under the second prong of the UCC definition, the financing of the Debtor's negative equity constitutes "value" given to enable the debtor to acquire rights in or use of the collateral.

The Bankruptcy Court erroneously concluded that the portion of the financing attributable to negative equity is not "value" given to "enable" the debtor to acquire rights in the collateral because in its view the negative equity is not part of the "actual price of the new item of collateral being acquired." 358 B.R. at 557. This analysis not only confuses the "price" prong with the "value to enable" prong, but it ignores the broad language of Comment 3 to UCC § 9-103, which applies to ***both*** prongs. Under the second prong of the definition, the term "purchase-money obligation" is defined as an obligation incurred "for value given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used." *E.g.* N.Y. U.C.C. Law

§ 9-103(a)(2) (McKinney 2006). Official Comment 3 then states that the term "value given to enable" includes "obligations for expenses incurred in connection with acquiring rights in the collateral . . . ."

The GMAC transaction at issue in this case fits this definition precisely. Just as the dealer gave "value" by agreeing to let Ms. Peaslee drive off in the new vehicle in exchange for her promise to pay over time, it also gave "value," as part of that installment sale transaction, by agreeing to take the trade-in vehicle upon which Ms. Peaslee owed $5,980 more than it was worth, thus "enable" the debtor to acquire the new vehicle. It was a package deal. The cost of satisfying Ms. Peaslee's negative equity obligation was "an expense incurred" in connection with her acquiring rights in the collateral. (*i.e.* the new vehicle). As assignee of the installment sale contract, GMAC stepped into the purchase-money shoes of the dealer. The "value" prong of the UCC definition of "purchase-money obligation" reflects the fact that, in the typical new car financing, the consumer is "enabled" to close the deal on the new vehicle only if he or she can satisfy the debt on the trade-in vehicle. Though the Bankruptcy Court suggests in note 12 of its opinion that consumers could pay off their negative equity by tapping other credit sources such as credit cards or home equity loans, some consumers don't own homes or don't want to pay the high interest rates imposed by credit card issuers. Moreover, trading in the old vehicle gives the consumer a market for its resale, thus relieving her of the burden of selling the vehicle herself. The financing of negative equity as part of a package is convenient, efficient and cost-effective—something that a huge percentage of consumers want to do and Congress wanted to protect.

The Bankruptcy Court also supports its conclusion that negative equity is not "value given" to "enable" with the anecdotal observation that negative equity is not a component of a

"majority" of motor vehicle financing packages. 358 B.R. at 557. The Court concludes that because it is not done by a majority of consumers, it is dissimilar to those expenses enumerated in Comment 3 to Section 9-103 that are incurred by all debtors acquiring similar collateral. *Id*. Yet all the studies cited earlier indicate that a very large percentage of consumers—probably more than a third, and perhaps as much as one half—***do*** finance negative equity. Moreover, the Bankruptcy Court's conclusion makes no sense because other items listed in Comment 3 to Section 9-103, such as attorneys' fees and expenses of collection, are also not incurred in a majority of motor vehicle financing transactions because a "majority" of purchasers do not go into default. There was a time when a majority of consumers did not obtain financing for motor vehicles with electric windows, airbags, seat heaters, or more recently, satellite radio and built in GPS. Because these luxury upgrades were not purchased and financed by a majority of consumers, however, does not mean that they were not a part of the financer's collateral and that they were not part of its purchase-money security interest. The fact that an expense incurred in connection with purchasing a motor vehicle is not incurred in a "majority" of transactions, or is theoretically "optional", is irrelevant to determining whether the cost is indeed entitled to purchase-money status under the second prong.

C. The Bankruptcy Court's Decision Contradicts the Long Line of Well Reasoned Judicial Authority that Supports GMAC's Position.

Section 1325(a)(*) of the Bankruptcy Code does not limit a purchase-money security interest on a motor vehicle to the sticker price of the vehicle in order to gain protection against cramdown. That is clear from the language and legislative history of the federal statute. It is clear from TILA. It is clear from the broad definition of "purchase-money security interest" found in the UCC. And it is clear from the language of the New York MVRISA. Moreover,

courts considering the issue in other jurisdictions have interpreted Section 1325(a)(*) in the manner urged by GMAC. There are two groups of cases, and they both point in the same direction.

i. The extended warranty cases.

A number of courts have considered whether financing other items included in the purchase price of a vehicle, like extended warranties, insurance and governmental fees imposed at the time the vehicle is purchased, is entitled to Section 1325(a)(*) protection. The courts have consistently found that the entire amount financed is protected from cramdown, even though some of the items are completely optional. For example, in *In re Murray*, 346 B.R. 237 (Bankr. M.D. Ga. 2006), the issue faced by the court was whether the secured creditor's claim qualified for purchase-money security interest treatment under Section 1325(a)(*), given that the debt included the purchase of an extended service contract and two documentary fees. The court found that the creditor's entire financing was entitled to protection from bifurcation under Section 1325(a)(*). The court stated that "[t]he simultaneous purchase of a motor vehicle and an extended service contract, with the inclusion of a documentary fee, does not prevent a creditor from taking a purchase-money security interest in the motor vehicle."[27]

ii. The negative equity cases.

The rationale of the cases involving the financing of optional items such as extended warranties and service contracts applies to negative equity. There are also at least four cases that directly protect negative equity. A Georgia decision on point is *In re Wible*, Case No. 06-40017

[27] *Id.* at 5-6. To the same effect is in *In re Johnson*, 337 B.R. 269 (Bankr. M.D.N.C. 2006).

(Bankr. M.D. Ga. June 26, 2006).[28] In *Wible*, as in the present case, the debtor purchased a new car and rolled debt owed on an old car into the new installment contract. The debtor then filed bankruptcy within 910 days of the financing. The debtor sought to bifurcate the secured creditor's claim based on the value of the vehicle, and argued at the hearing that the claim was not entitled to protection under Section 1325(a)(*). The creditor objected on the ground that under Section 1325(a)(*) the claim could not be bifurcated.

The court found in favor of the creditor. Relying on UCC § 9-103, the court held that the entire transaction, including the payment of the debtor's negative equity on the trade-in, enabled the debtor to acquire rights in and use of the new vehicle, and therefore qualified as part of a "purchase-money" obligation entitled to Section 1325(a)(*) protection. The court said this: "[I]t seems to me that this transaction, including the extra $2,900 [negative equity], was to enable the debtor to acquire rights in and the use of this collateral and therefore I'm going to hold that this was subject -- that this is subject to 910 [*i.e*. protected by the hanging paragraph]." *Id.* at p. 27, ln. 13-16. The court distinguished the situation before it -- where the financing for the vehicle and other items was simultaneous and part of a single secured transaction -- from cases involving a series of transactions. *Id*. at p. 27, ln. 2-4 ("But those cases and all the cases [debtor's counsel] said that he's relying on do involve refinancing, rollovers, consolidations and are factually distinguishable.").[29]

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[28] The judge in *Wible* rendered this decision orally and without written opinion. A copy of the transcript is attached as Addendum D.

[29] One court that has reached the opposite conclusion is *In re Vega*, 2006 WL 1731224 (Bankr. D. Kan.). However, that case is distinguishable because it involved multiple credit transactions with the same creditor rather than a single financing package. Another Kansas case that follows *Vega* is *CitiFinancial Auto v. Hernandez-Simpson*, 2007 WL 1464258 (D. Kan. 2007).

A North Carolina decision that follows the lower court in this case is *In re Price*, 2007 WL 664534 (Bankr. E.D.N.C. 2007). It is GMAC's position that the North Carolina Bankruptcy Court, like the Bankruptcy Court in the

A second negative equity case from Georgia that supports GMAC is *In re Graupner*, 356 B.R. 907 (Bankr. M.D. Ga. 2006). In that case, the court held that the negative equity on a trade-in vehicle constituted a "purchase-money obligation" under Article 9 of the UCC and was thus protected from cramdown. In reaching this decision, the court focused on a 1999 amendment to the Georgia installment sales statute strikingly similar to the 1994 amendment in New York. The Georgia amendment, like the New York amendment, bundled together all elements of a purchase-money financing authorized by the statute: taxes; registration, title license and "other fees;" charges for servicing and repairing the vehicle; and "any amount paid to the buyer or a third party on behalf of the buyer to satisfy a lease on or a lien on or a security interest in a motor vehicle used as a trade-in on the motor vehicle which is the subject of a retail Installment transaction under this article." The court held that this special statute must be read *in pari materia* with the UCC definition of "purchase-money obligation." Relying on Comment 3 to UCC § 9-103, the court concluded that the term "price" as used in the UCC should be broadly construed to include "other costs related to and contemporary with the purchase of the collateral." The court also pointed out that the Installment sale statute was in fact limited to purchase-money security interests originated by sellers—just as it is in New York.

A third negative equity case strongly supporting GMAC's position is *In re Honeycutt*, Case No. 06-48771 (Bankr. E.D. Mich. 2006) (no written opinion; transcript attached as Addendum B). In that case, involving the trade-in of a leased Ford Explorer for a new Ford Taurus, the $6,300 unpaid balance on the leased Explorer was included in the contract price of

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present case, is wrong. The *Price* case is presently on appeal to the federal district court. *In re Westfall*, 2007 WL 891730 (Bankr. N. D. Ohio, 2007), follows *Peaslee* and *Price*, but the court in the Ohio case has asked for additional briefing and was apparently unaware of the 1990 Ohio Supreme Court decision, *Johns v. Ford Motor Credit Co.*, 551 N.E.2d 179 (Ohio 1990), which holds that negative equity must be considered as part of the new vehicle's "cash price" so long as the dealer and the buyer bargained for that price in good faith.

the Taurus, along with "gap" insurance, license, and registration fees. The debtor made a down payment of $700 and got a rebate of $5,500, which offset all but $100 of the $6,300 unpaid lease balance.

The debtor contended that including the $6,300 lease balance deprived the Taurus contract of its purchase-money status. The court rejected that argument. In treating the $6,300 negative equity as part of the debtor's "purchase-money obligation," the court relied heavily on Official Comment 3 to UCC §9-103, under which both the "price" of the collateral and the "value given to enable" its purchase include "obligations for expenses incurred in connection with acquiring rights in the collateral." In order to purchase the new vehicle, the debtor "was compelled to dispose of the lease and any obligations attendant to the lease." The inclusion of the lease balance was an "expense" incurred in connection with the debtor's acquisition of the Taurus. Payoff of the lease balance "enabled" the debtor to acquire the new vehicle. It also became part of the "price." In other words, negative equity satisfied ***both prongs*** of the UCC definition of "purchase-money obligation." The Michigan court also found that the rationale of cases protected optional items like extended warranty coverage extends to negative equity.

The Michigan court distinguished cases where a single creditor refinances a vehicle purchase-money obligation and sometimes adds cash as a sweetener. Those cases involve multiple transactions with a single creditor seeking to retain purchase-money status with respect to the ***original collateral***. In the service contract and negative equity cases, by contrast, there is only ***one transaction*** for the purchase of the new vehicle that will serve as purchase-money collateral. That transaction involves a "purchase-money obligation" that is protected from bifurcation.

Finally, the Michigan court rejected the debtor's argument that the contract price had

been manipulated by the secured creditor with an evil intent to change unsecured debt into secured debt in anticipation of bankruptcy. It was the ***debtor*** who preferred to include her negative equity into the new contract. "She could have continued to make her lease payments in addition to payments on a new car, but she chose not to do so." The contract price was arrived at by good faith "horse trading," which is common in the industry. The purchase price was a "package deal." Like the Georgia decisions, the Michigan decision is directly on point.

A fourth case that supports GMAC's position is *Johns v. Ford Motor Credit Co.*, 551 N.E.2d 179 (Ohio 1990), where the court 17 years ago held that negative equity was included in the "price" of the new car for purposes of the Ohio Retail Installment Sales Act so long as it was bargained for by the parties in good faith. Significantly, the Ohio Supreme Court in *Johns* recognized that the Ohio Retail Installment Sales Act – pursuant to which the court concluded negative equity was properly included in the "price" of the vehicle – was enacted to correct abusive practices in the automobile financing industry. *Id.* at 182.

Thus, the Bankruptcy Court's notion that including negative equity in the "price" of the collateral is somehow an abuse of the priority system in bankruptcy because it is converting unsecured debt into secured debt to the detriment of unsecured creditors (*Peaslee*, 358 B.R. at 556) is novel and incorrect. The longstanding and judicially-sanctioned idea that negative equity is properly part of the "price" of a motor vehicle in fact reduces abuse in the industry.

Despite the authority holding that the financing of a new vehicle purchase that includes negative equity is a single purchase-money obligation, the Bankruptcy Court concluded that Ms. Peaslee's package financing was really "two separate financial transactions memorialized on a single retail Installment contract document for the convenience of some consumers and to allow the auto industry to sell more vehicles, which is good for both parties." *Id.* at 558. This

characterization of a financing package as two transactions is simply incorrect. The whole idea of the New York MVRISA is to authorize the motor vehicle dealer to finance both elements as a single "package." The collateral is limited to a single item—the new vehicle – and there was no refinancing of the negative equity; the dealer simply agreed to pay-off a lien on the trade-in vehicle and added the expense of doing so to the price. The consumer views it as a package deal. TILA views it as a package deal. When they drafted the hanging paragraph, Congress knew that the trade-ins are part of a package deal in new car financings. The UCC definition of PMSI treats it as a package deal. And a majority of other bankruptcy courts that have addressed the issue view the financing as a "package" that is entitled to purchase-money status.

II. THE BANKRUPTCY COURT ERRED IN APPLYING THE "TRANSFORMATION RULE" TO THE FINANCING AT ISSUE

After issuing a ruling that contradicts the plain language of the hanging paragraph and its legislative history, the definitions in TILA, the New York MVRISA, and the UCC, and ignores a majority of cases that have squarely addressed the issue, the Bankruptcy Court put the final nail into GMAC's coffin by invoking the "transformation rule."

If this Court determines that negative equity is not part of the "price" of the motor vehicle or "value given to enable the debtor to acquire rights and/or use of" the motor vehicle, then it must decide whether to follow the transformation rule as suggested by the Bankruptcy Court, or to apply what the modern trend of case law recognizes as the "dual-status rule." Courts that apply the transformation rule hold that "if an item of collateral purports to secure not only its own purchase price but also that of other items, the security interest that existed before the 'add on' procedures is transformed into non-purchase-money status. Those courts reason that because the item secures more than its own price, "there is no longer a 'pure' purchase-money security

interest and consequently that lien disappears." *In re Pristas* 742 F 2d 797, 800 (3rd Cir. 1994).

The alternative is to apply the dual-status rule, which provides that "the presence of a non-purchase-money security interest does not destroy the purchase-money aspect." *In re Pristas* 742 F 2d 797, 800 (3rd Cir. 1984). "The dual-status rule is sensitive to the policy concerns in [Section 9-103] . . . and supportive of a public policy encouraging refinancing . . . . These policy considerations are a benefit to both buyer and seller to facilitate the sale of consumer goods." *Borg-Warner Acceptance Corp. v. Tasoca National Bank* 784 S.W. 2d 129, 135 (Tex 1990). The choice between the transformation rule and the dual-status rule is only reached in the context of the hanging paragraph if the Court concludes that there are multiple obligations -- some purchase-money and some not.

The justification that the Bankruptcy Court offers for its application of the transformation rule – that it will constrain the discretion of bankruptcy court judges – could be reached more directly by simply treating negative equity as a purchase-money obligation. This eliminates all discretion because courts never reach the transformation rule. The only discretion that the court must exercise is whether any of the debt finances expenses that have no close nexus with the new car financing—such as a trip to Las Vegas. That's a manageable standard that the Bankruptcy Court can apply. It is the standard that ***should*** be applied. *See, e.g.*, Comment 3 to UCC 9-103: "The concept of a 'purchase-money security interest' requires a close nexus between the acquisition of collateral and the secured obligation." In New York, the problem is solved because the dealer is not authorized by the New York MVRISA to finance something unrelated, like a trip to Las Vegas, by making a cash advance to the buyer.

A. Even If Only a Portion of the Cash Price is Entitled to Protection Under § 1325(a)(*), Case Law is Clear that the Remainder of the Cash Price is Always Protected.

The Bankruptcy Court concluded that since the transaction granting the security interest included negative equity, the protection under Section 1325(a)(*) does not apply to ***any*** element of the financing, so that the ***entire*** claim is subject to bifurcation under Section 506. However, contrary to the lower court's analysis, even where a court has found that the portion of the financing for other items was not entitled to Section 1325(a)(*) protection, the remainder of the amount financed is still protected. As a result, most courts never reach the issue of whether, assuming a ***portion*** of the financing is not entitled to Section 1325(a)(*) protection, the remainder is still protected.[30] For example, in *In re Vega*, 2006 WL 1731224 (Bankr. D. Kan. 2006), the Kansas court still protected the balance of the creditor's claim under Section 1325(a)(*).[31] The court stated that "debtors' Chapter 13 plan meets the provisions of 11 U.S.C. § 1325(a) in providing full payment of that portion of UAC's claim representing its purchase-money security interest in the 1996 Intrepid, with interest." *Id.* at *5. As discussed above, in its holding that negative equity was not protected, the *Vega* case is distinguishable from the present case in that it involved multiple credit transactions from the same creditor.

B. The "Transformation Rule" that Some Courts Have Applied in the Context of Lien Avoidance under Section 522(f) Does not Apply to Section 1325(a)(*) Vehicle Financing.

[30] There appear to be two recent cases to the contrary. One of them is *In re Price*, 2007 WL 664534 (Bankr. E.D.N.C. 2007) (following *Peaslee* and presently on appeal to the federal district court), and *In re Westfall*, 2007 WL 891730 (Bankr. N. D. Ohio, 2007), in which the Bankruptcy Court appears to have been unaware of the existence of the Ohio Retail Installment Sales Act discussed by the Ohio Supreme Court in *Johns v. Ford Motor Credit Co.*, 551 N.E.2d 179 (Ohio 1990)).

[31] The case of *In re White*, 2006 WL 2827321 (E.D.La. Bankr. 2006) is distinguishable because it did not involve negative equity, it involved an extended service contract and insurance deficiency coverage, which the Court found were not included in the purchase-money security interest, but this holding did not affect the cash purchase price portion of the financing, which still qualified for protection under § 1325(a)(*).

For a variety of reasons, the transformation rule should not be applied to Section 1325(a)(*) motor vehicle financing transactions. The transformation rule arose primarily from courts interpreting Section 522(f) of the Bankruptcy Code and finding that a purchase-money security interest in consumer goods is "transformed" into a non-purchase-money security interest where the collateral secures more than its own price.[32]

Other courts apply the "dual-status rule" under which only that portion of the debt that is determined to be a non-purchase-money obligation is affected. The remaining portion of the claim retains its purchase-money status. For a variety of reasons, the transformation rule should ***not*** be applied to Section 1325(a)(*) motor vehicle financing transactions.

First, as stated above, all the Section 522(f) cases that discuss transformation of a purchase-money security interest, involve a subsequent debt or a combination of debts where each new obligation continues to be secured by the purchase-money collateral initially securing the first obligation, rather than the original debt secured by the collateral. The rule simply does not apply in the situation where the original financing is secured by the collateral purchased, or even when the original loan amount is refinanced. *See e.g., In re Clark*, 156 B.R. 693, 695 (Bankr. S.D. Fla. 1993) ("This policy is not served by applying the transformation rule in a refinancing case."). In fact, new car financings that include a payoff of the negative equity from a trade-in vehicle, or insurance and service contracts related to the financing, don't involve any "transformation" at all. They are all part of a single transaction that gives rise to the security interest in the new vehicle for the first and only time.

[32] Section 522(f) provides in pertinent part that, "[t]he debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled . . . if such lien is . . . a nonpossessory, nonpurchase-money security interest in . . . household furnishings [or] household goods. . ."

Second, of the courts considering the issue under Section 522(f), a substantial number reject the transformation rule in favor of the "dual-status rule." *See, e.g., Billings v. Avco Colorado Industrial Bank (In re Billings)*, 838 F.2d 405, 409 (10th Cir. 1988) (refinancing did not destroy purchase-money security interest); *Pristas v. Landaus of Plymouth, Inc. (In re Pristas)*, 742 F.2d 797, 801 (3rd Cir. 1984) (consolidation of debt and "add on" to security agreement did not destroy purchase-money security interest); *In re McAllister*, 267 B.R. 614, 621 (Bankr. N.D. Iowa 2001) (inclusion of after-acquired property and future advances clauses did not terminate creditor's purchase-money security interest).[33] Significantly, a number of the cases that adopted the dual-status rule under pre-revised UCC Section 9-107 (now 9-103) did so based on the language in the preamble to the definition of "purchase-money security interest," which stated: "A security interest is a 'purchase-money security interest' *to the extent that it is*…" *In re Russell*, 29 B.R. 270, 272 (Bankr. W.D. Okla. 1983) (emphasis added).[34] The courts reasoned that "the only way 'to the extent' can be given meaning is to find that a secured debt may be split

[33] *See also In re Clark*, 156 B.R. 693, 695 (Bankr. S.D. Fla. 1993) (refinancing did not destroy purchase-money security interest); *In re Johnson*, 101 B.R. 280, 282 (Bankr. W.D. Okla. 1989) (refinancing did not destroy purchase-money security interest); *In re Parsley*, 104 B.R. 72, 75 (Bankr. S.D. Ind. 1988) (refinancing and cross-collateralization did not destroy purchase-money security interest); *In re Hemingson*, 84 B.R. 604, 608 (Bankr. D. Minn. 1988) (refinancing did not destroy purchase-money character of security interest); *Bond's Jewelers, Inc. v. Linklater (In re Linklater)*, 48 B.R. 916, 919 (Bankr. D. Nev. 1985) (loan consolidation did not destroy purchase-money security interest); *In re Russell*, 29 B.R. 270, 273 (Bankr. W.D. Okla. 1983) (dual-status rule applies in a loan consolidation involving a cash advance); *In re Conn*, 116 B.R. 454, 460 (Bankr. KY. 1982) (adopts dual-status rule in loan consolidation transaction); *Stevens v. Associates Financial Services*, 24 B.R. 536, 539 (Bankr. D.Colo. 1982) (applying dual-status rule on a case by case basis); *In re Gibson*, 16 B.R. 257, 266-269 (Bankr. D. Kan. 1981) (refinancing and cross-collateralization do not destroy purchase-money security interest).

[34] *See also, In re Air Express,* 136 B.R. 328, 332 (Bankr. D Mass. 1992) ("to rule otherwise [than to adopt the dual-status rule] would mean rewriting the first phrase of UCC § 9-107. It now begins, 'a security interest is a purchase-money security interest *to the extent that it is*…' To decide otherwise would have it read, 'a security interest is a 'purchase-money security interest' *if it is*…") (emphasis in original); *In re Geist*, 79 B.R. 939, 942 (D.Wy. 1987) ("This Court accepts the 'dual-status' rule because it give effect to the preamble of U.C.C. § 9-107. The 'transformation rule' on the other hand is unacceptable because it ignores the critical language of § 9-107 – 'to the extent that.'"); *In re McCall*, 62 B.R. 57, 59 (D. M. D. Ala. 1985) ("the seller can still hold a purchase-money security interest in the goods 'to the extent' those goods secure their own price.").

into two parts, a purchase-money part constituting so much of the debt as represents the price of the collateral and a nonpurchase-money part constituting the 'add on' debt." *Id*. In the revised UCC, Section 9-103 retains the "to the extent" language in the definition of "purchase-money security interest," stating: "[a] security interest in goods is a purchase-money security interest: (1) *to the extent that* the goods are purchase-money collateral with respect to that security interest." UCC § 9-103(b) (emphasis added). Because the revised Code retains the "to the extent" language, adopting the transformation rule ignores the plain language of Section 9-103.

Third, even if this Court were of the opinion that the transformation rule should apply for purposes of Section 522(f), the legislative history of that statute confirms that its purpose is unrelated to motor vehicle financing. Rather, the statute was intended to allow debtors to avoid security interests in their already-owned household goods as a way of protecting exempt assets: "The exemption provision allows the debtor, after bankruptcy has been filed . . . to undo the consequences of a contract of adhesion, signed in ignorance, by permitting the invalidation of nonpurchase-money security interests in household goods. Such security interests have too often been used by over-reaching creditors. The bill eliminates any unfair advantage creditors have."[35] The transformation rule is not applicable to the situation at hand, where the collateral is a motor vehicle which the financing enabled the debtor to buy. In fact, the whole purpose of the "hanging paragraph" enacted by Congress in 2005 is to ***protect motor vehicle financers from cramdown*.** Invoking the transformation rule in this context would completely undercut the purpose of the "hanging paragraph."

[35] H.R.Rep. No. 95-595, 95th Cong., 1st Sess. 127 (1977) U.S. Code Cong. & Admin. News 1978, pp. 5787, 6088. *See also In re Gibson*, 16 B.R. 257, 266 (Bankr. D. Kan. 1981) ("Thus Congress enacted § 522(f) to allow the consumer debtor to avoid security interests in their already owned, used household goods, . . . and not security interests in collateral which the money advanced was used to purchase.").

In enacting Section 522(f), Congress sought to prevent creditors from overreaching by obtaining liens on household goods already owned by the debtor, thus clogging the exemption policy in bankruptcy. That statutory purpose does not apply to the type of motor vehicle financing in this case, where there is no cross-collateralization and the only collateral is a new vehicle provides the purchase-money finance contract which was purchased by GMAC. Neither the transformation rule nor Section 522(f) can destroy the purchase-money status of GMAC's secured claim. In short, the trend in the cases has been away from the transformation rule, particularly outside the context of Section 522(f) of the Bankruptcy Code.

C. New York State and Bankruptcy Court Decisions Explicitly Reject the "Transformation Rule."

Both the Bankruptcy Court and the trustee ignore the longstanding New York state and bankruptcy court case law that explicitly rejects the transformation rule. In *The National Cash Register Co. v. Mishkin's 125th Street, Inc*., 317 NYS 2d 437 (N.Y. Civ. Ct. 1970), the New York Civil Court rejected the transformation rule and concluded that "[d]efendant has a purchase-money interest also as same is defined in [former] Section 9-107 UCC. There is no basis for holding of the nature of its interest have been changed because it included an after acquired property provision." *Id.* at 440.

This decision was followed by two bankruptcy court decisions rendered in 1991. In the first decision, the bankruptcy court for the Southern District of New York examined both the transformation rule and the dual-status rule, and concluded that "the more modern trend is to recognize that only the security interest which secures the non-purchase price debt is not a PMSI, but the interest which secures the purchase price debt retains its PMSI character." *In re Ionosphere Clubs, Inc.,* 123 B.R. 166, 171 (Bankr. S.D.N.Y. 1991). The *Ionosphere* court

recognized that, "under this approach the relevant question is whether the financing party takes an interest in the collateral as security for the purchase price obligation, not whether the purchased property also serves or will serve as collateral for other debts of the purchaser." *Id.* Two months later the bankruptcy court for the Southern District of New York followed the reasoning in *Ionosphere* in *In re Pan Am Corp*., 124 B.R. 960 (Bankr. S.D.N.Y. 1991), finding that a loan that involved cross collateralization of pre-existing debt did not lose its PMSI character. *Id.* Thus, to the extent that the court looked to New York law for the definition of a purchase-money security interest, the court also should look at case law interpreting that state law, which flatly rejects the transformation rule.

D. The Transformation Rule is Inconsistent With the Intent of the Drafters of the UCC.

GMAC urges this Court to exercise its discretion in favor of the dual-status rule, which is consistent with the text of Section 9-103 of the UCC, the Official Comment to § 9-103, and the drafters' intent. Section 9-103 of the UCC defines purchase-money security interest and specifically adopts the "dual-status rule" for ***commercial*** transactions. Subsection (h) states that "the court may not infer from the limitation the nature of the proper rule in ***consumer*** goods transactions and may continue to apply established approaches." (emphasis added). Official Comment 7 to UCC Section 9-103 states that "for transactions other than consumer goods transactions, this article approves what some cases have called the 'dual-status' rule, under which a security interest may be a purchase-money security interest to some extent and a non-purchase-money security interest to some extent."

Most commentators agree that this distinction between commercial transactions and consumer transactions was not made because the drafters thought the transformation rule was

proper in consumer cases, but rather because it was a necessary political compromise. For example, White & Summers conclude that "by setting out explicit rules that generally favor purchase-money status in business transactions, *the drafters show that they understood the proper rules and have the capacity to spell them out with clarity*. It is regrettable they did not apply the same rules to consumer transactions, but, at least, they left the courts free to apply the business rules by analogy to consumer cases." James J. White & Robert S. Summers, *Uniform Commercial Code Practitioner Treatise Series* § 31-6 (5th ed. Supp. 2006) (emphasis added).

Another commentator has noted that "the exclusion of consumer transactions from the clarification and the allocation formula in Section 9-103 is the result of the article 9 drafters' consumer compromise."[36] Thus, the drafters did not leave uncertainty in the realm of consumer cases because they thought the transformation rule was proper; they were forced to sacrifice mandating the dual-status rule in all consumer cases to ensure adoption of the UCC, thereby fostering the goal of uniformity to permit "expansion of commercial practices," UCC § 1-103.

Based upon this legislative history, if it concludes that the negative equity cost in this case is not part of a purchase-money obligation, this Court should have no hesitation in applying the dual-status rule in consumer cases, as encouraged by Professors White and Summers.

E. Application of the Dual-Status Rule to Section 1325(a)(*) Vehicle Financing Can be Accomplished Without an Evidentiary Hearing.

If this Court reverses the Bankruptcy Court and concludes that negative equity for trade-in vehicles, costs for insurance and service contracts, and other transaction-related fees are all part of a single "purchase-money obligation," then it will not need to deal with the

[36] Juliet M. Moringiello, *A Tale of Two Codes: Examining Section 522(f) of the Bankruptcy Code, Section 9-103 of the Uniform Commercial Code and the Proper Role of State Law in Bankruptcy*, 79 Wash. U.L.Q. 863, fn. 25 (Fall 2001).

"transformation rule" issue. If this Court concludes otherwise, it can fashion a workable allocation between the protected and unprotected portions of GMAC's claim by pro-rating the amount paid by the Debtor in the same ratio as the amount of the PMSI portion of the total amount financed to the non-PMSI portion of the total amount financed. For example, using the facts of this case, the total amount financed was $23,180.00. If the court determines that the negative equity of $5,980.00 is not entitled to PMSI protection, then the pre-bankruptcy payments by the Debtor should be allocated as follows: $5,980.00/$23,180.00, or 25.80% to non-PMSI and $17,200.00/$23,180.00, or 74.20% to PMSI. As of the filing, GMAC was owed $17,904.95. Allocating this claim using the percentages based upon the ratio of PMSI to non-PMSI in the original installment sale contract, GMAC would have a PMSI claim in the amount of $13,285.47 (calculated by multiplying $17,904.95 by 74.02%) and a non-PMSI claim in the amount of $4,619.48 (calculated by multiplying $17,904.95 by 25.80%).

In this case, the Bankruptcy Court applied the transformation rule in part to avoid the "evidentiary nightmare" that would result if courts had to allocate claims using the dual-status rule. *See*, *Peaslee*358 B.R. at 558. This concern is illusory. As demonstrated by the foregoing example, all of the information needed to allocate the claim under the dual-status rule is contained on the creditor's proof of claim. So long as the creditor files a claim (or provides the equivalent information in a motion or informally to the Trustee), allocation would not require an evidentiary hearing; it would only require the trustee to verify the creditor's calculations, a process that would not take longer than five minutes. Thus, given the drafters' preference for the dual-status rule and the ease of application, GMAC submits that it is the proper rule for this Court to adopt.

CONCLUSION

The Golden Rule of statutory construction is to interpret statutory language, if possible, in a way that best fits the purpose of the statute. The hanging paragraph that Congress added to the Bankruptcy Code clearly was intended to curb the abusive use of cramdowns by consumer debtors who incur secured debt shortly before filing a Chapter 13 bankruptcy petition and then invoke the cramdown rule to extinguish a large portion of their secured creditor's claim. Indeed, the House Report discussion of the hanging paragraph is captioned "Giving Secured Creditors Fair Treatment in Chapter 13."[37] The lower court decision perpetuates the very abuse that Congress sought to remedy and will serve to increase the cost of secured credit for all consumers, including those not in default. By effectuating a return to cramdown *status quo* that existed prior to the enactment of the BAPCPA, the lower court decision effectively repeals the hanging paragraph with respect to a huge percentage of vehicle financings. This Court should construe the statutory language in a way that avoids such an unintended result.

A construction of the hanging paragraph that promotes the statutory goal is compelled by a combination of federal and state law. One can presume that when Congress amended Section 1325 and left the term "purchase money security interest" undefined, it was looking to trade practice, other federal law and state law to give meaning to that term and to effectuate its intent in enacting the hanging paragraph. At the time the hanging paragraph was enacted, a majority of states (including New York) had laws governing motor vehicle retail installment sales that expressly authorized the financing of negative equity as part of a purchase-money package deal bargained for in good faith by dealer and consumer. For years, that has been the standard

[37] H.R. Rep. 109-31 at 71-72, 2005 U.S.C.C.A.N. 88, 139-40.

industry practice. The UCC -- a body of "national commercial law" -- specifically provides that it should be construed "to permit the continued expansion of commercial practices through custom, usage and agreement of the parties." N.Y. U.C.C. § 1-102(1)(b). Another federal statute enacted by Congress – TILA -- reflected trade practice by defining negative equity as part of the "Total Sale Price" under a motor vehicle Installment sale contract.

As consumers, members of Congress would understand that payoff of the prior lien on a trade-in is an "expense incurred in connection with" acquiring the new vehicle, which is exactly how the UCC defines a "purchase money security interest." All three of the pre-existing statutes relevant to purchase-money automobile financing -- TILA, state laws governing motor vehicle retail Installment sales, and Article 9 of the UCC – had codified trade practice by treating negative equity as part of the purchase money obligation under a retail Installment sale contract. Accordingly, all three of the relevant laws in effect prior to the BACPA amendment support the position of GMAC and the goal of eliminating abusive cramdowns that Congress sought to be achieve in enacting the hanging paragraph.

For these reasons, GMAC's entire claim -- including the negative equity obligation -- should be treated as secured and paid in full. GMAC respectfully requests that this Court reverse the Bankruptcy Court's December 22, 2006 Decision and Order and its Confirmation Order.

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Respectfully submitted,

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